B4750-1A

Financial Markets

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research & Planning Division

Friday (Noon) July 13, 1984

The Federal Reserve is back in its most comfortable role: It is tightening. Fed funds are trading above 11% persistently, a clear step up from their 10½% level when Continental Illinois developed funding problems. Thus the Fed paused in its tightening for less than one month to "calm" the markets. Under Mr. Volcker's chairmanship, the Fed has seemingly been more comfortable tightening than easing. This conclusion follows from the observation that interest rates have increased at a fairly steady pace when they have been rising; but when rates have fallen, they generally have plummeted. The Fed has usually postponed easing until it seemed overdue to the market or until some crisis has precipitated the change. Some examples here are useful.

Since the Fed adopted operating procedures geared to fight inflation in October of 1979, the Fed has eased substantially only twice. The first time was not even a deliberate choice but followed instead from the imposition of credit controls in March of 1980 and the contraction that they produced in the economy and the monetary aggregates. The second easing was precipitated by severe debt problems in the LDCs in mid-1982 and represented a concerted Fed response to that crisis.

The Fed under Volcker has always seemed to have a bias to be on the tight side. Rates generally have risen gradually over long periods of time and fallen sharply over short time spans under his guidance. The funds rate rose from 12% in October of 1979 to over 19% by the end of the first quarter of 1980 (almost six months). In the space of one quarter, this increase was more than reversed as Fed funds fell below 9%. It then took another six months to get the Fed funds rate back up again to 19%. In early 1981 funds fell again, by 5 percentage points, to 15% in one quarter's time. The funds rate rose over the next quarter back to 19% near mid-1981. Fed funds then fell 6 percentage points in a three-and-a-half-month span at year-end. In two months' time, however, rates were back up by 3 percentage points; then they stayed at about the 15% level until the Fed eased in mid-1982.

Since then the Fed's policies have produced less volatile rates. Yet it is useful to bear in mind the Fed's underlying inclinations, especially its tendency to tighten gradually until some significant change occurs. Also we should keep in mind that under the Fed's operating procedures from October 1979 until mid-1982, the market played a much greater role in determining the Fed funds rate than it has since. Thus one thing this history lesson seems to say is that the market will rally with much greater enthusiasm ahead of a Fed that is easing than it will back up ahead of a Fed that is tightening. Given this is the case, we can see why the Fed prefers to maintain a tight policy: It has more control over rates; there is more friction in the system.

Judging from past experience we should expect the Fed to continue to tighten until there is a fundamental change in the economy or some clear and present danger. The Fed did get cold feet and ease somewhat in late 1983 as it felt the economy was weakening. But the economy did not weaken. This mistake should only strengthen the Fed's resolve to keep tight and not make the same mistake again. We therefore continue to wait for the event--a slower-growing economy or something else--that will put the Fed on a less restrictive course.

Robert A. Brusca

Irving Trust

Market Yields

	7/13/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	13.00%	13.00%	10.50%
Effective since	6/25/84		
Discount Rate at Federal Reserve Bank	9.00	9.00	8.50
Federal Funds	10.81	11.00	9.38
Repurchase Agreements	10.75	10.50	9.25
U.S. Treasury Issues			
Bills			
3 months	10.33	10.41	9.42
6 months	11.10	11.17	9.92
1 year	11.90	12.10	10.27
Coupons			
2 years	12.81	13.12	10.76
4 years	13.10	13.56	11.19
7 years	13.23	13.79	11.39
10 years	13.24	13.82	11.42
Long Bond	13.05	13.63	11.43
Negotiable Certificates of Deposit-Secondary Market			
1 month	11.15	11.40	9.30
3 months	11.48	11.75	9.55
6 months	12.05	12.25	10.05
1 year	12.80	13.15	10.40
Banker's Acceptances			
1 month	11.41	11.51	9.32
3 months	11.75	11.90	9.70
6 months	12.27	12.49	10.05
Eurodollar Deposits			
1 month	11.38	11.81	9.82
2 months	11.75	12.06	10.00
3 months	11.88	12.31	10.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.16	11.18	9.27
1 month	11.31	11.41	9.45
3 months	11.31	11.31	9.74
Bank Holding Companies			
1 month	10.89	11.00	9.07
Dealer Placed:			
3 months	11.84	11.68	9.62
New AA Corporate Utility Bond	14.38	14.85	12.60
Tax Exempt			
6 month Project Notes	5.80	5.80	4.90
1 year AAA Bond	6.40	6.60	5.50
5 year AAA Bond	8.10	8.10	6.75
20 year AAA Bond	10.05	10.20	8.75

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629